

JOHN T. BADHAM TESTAMENTARY	§	STATE OF ALABAMA
MARITAL TRUST		DEPARTMENT OF REVENUE
AmSouth Bank N.A.	§	ADMINISTRATIVE LAW DIVISION
Post Office Box 11426		
Birmingham, Alabama 35202,	§	
Taxpayer,	§	DOCKET NO. INC. 94-402
v.	§	
STATE OF ALABAMA	§	
DEPARTMENT OF REVENUE.		

OPINION AND PRELIMINARY ORDER

The Revenue Department entered a final assessment of estate/fiduciary tax against the John T. Badham Testamentary Marital Trust for the year 1991. The Trust appealed to the Administrative Law Division, and a hearing was conducted on January 9, 1995. Tom Brinkley and Reese Murray represented the Trust. Assistant Counsel Beth Acker represented the Department.

The Estate of Margaret O. Badham ("Estate") incurred an additional estate tax liability because certain qualified terminable interest property ("Q-TIP" property) from the John T. Badham Testamentary Marital Trust ("Trust") was included in the Estate for estate tax purposes. The Trust was required by 26 U.S.C. §2207A and the will of John T. Badham to reimburse the Estate for the amount of the additional estate tax attributable to inclusion of the Q-TIP property in the Estate. The issue in this case is whether the Trust can deduct on its 1991 fiduciary return the amount paid to the Estate as estate taxes paid by the Trust.

The facts are undisputed.

John T. Badham was married to Margaret O. Badham. The will of John T. Badham

created the John T. Badham Testamentary Marital Trust. The will further provided in part as follows:

"If any principal of the marital trust shall be included in the gross estate of the beneficiary for the purpose of any estate, inheritance, transfer, legacy, succession or death taxes and duties, then, unless the will of the beneficiary directs otherwise, the trustee shall pay, upon written request, to the personal representative of the estate of the beneficiary an amount equal to the difference between (a) the amount of all such taxes and duties, including any interest or penalties thereon, payable with respect to all property includible in the gross estate of the beneficiary, and (b) the amount of all such taxes and duties which would have been payable if such principal of the marital trust were not included in the gross estate of the beneficiary."

John T. Badham died on March 22, 1989. The estate's fiduciary elected to treat certain property in the Trust as Q-TIP property. The effect of that election was that the designated Q-TIP property was not included in the estate of John T. Badham for estate tax purposes. Rather, the property would be includable in the estate of the surviving spouse, Margaret O. Badham.

Margaret O. Badham died in 1991. The Q-TIP property from the Trust was included in her estate for estate tax purposes. In accordance with the will of John T. Badham, and as required by 26 U.S.C. §2207A, the trustee of the Trust paid to the executor of the Estate of Margaret O. Badham an amount equal to the federal estate tax owed by the Estate attributable to inclusion of the Q-TIP property in the Estate.

AmSouth Bank acted as both trustee of the Trust and executor of the Estate of Margaret O. Badham. Consequently, for internal bookkeeping purposes, AmSouth transferred the amount in question from the account of the Trust to the account of the Estate. AmSouth then wrote a check from its common checking account in the name of the Estate and payable to the IRS for the estate tax owed by the Estate.

The Trust subsequently filed its 1991 Alabama fiduciary return and deducted the amount transferred to the Estate as federal estate taxes paid by the Trust. The Revenue Department denied the deduction and entered the final assessment in issue based on its position that the taxes were not imposed on the Trust, and thus could not be deducted by the Trust. The Trust subsequently appealed to the Administrative Law Division.

Code of Ala. 1975, §40-18-15(a)(3) provides that an individual can deduct all taxes imposed on and paid by the individual during the tax year. Code of Ala. 1975, §40-18-25 imposes a tax on estates and trusts and provides in part that "[T]he net income of the estate or trust shall be computed in the same manner and on the same basis as provided in this chapter for individual taxpayers". See also, Department Reg. 810-3-25-.01(2)(a). Taxes imposed on and paid by an estate or trust can thus be deducted on the fiduciary return of the estate or trust. See also, Department Reg. 810-3-25-.01(2)2.(i).

Under Alabama law, tax can be deducted only if paid by the taxpayer against whom the tax is imposed. State v. Kilborn, 340 So.2d 447 (Ala.Civ.App. 1976); Sloss v. State, 89 So.2d 174 (1956). Department Reg. 810-3-15-.04(1)(d) also states that "taxes are deductible only by (the) taxable entity on whom (the) taxes are imposed". This case thus turns on whether the estate taxes in question were imposed on the Estate, or on the Trust.

Federal estate taxes are imposed on and payable by the executor of the estate. If the estate includes Q-TIP property, §2207A requires the trustee of the Q-TIP trust to reimburse the estate for the estate tax liability attributable to inclusion of the Q-TIP property in the estate. However, the estate and not the trust is still liable to the

government for the tax. Section 2207A does not shift the legal incidence of the estate tax to the trust. It only allows the estate to recover from the trust the additional tax owed by the estate attributable to the Q-TIP property.

The will of John T. Badham also required AmSouth, as trustee of the Trust, to pay to the personal representative of the Estate an amount equal to the estate tax attributable to the Q-TIP property. That provision in the will only tracked the requirements of §2207A. It did not and could not shift the legal incidence of the estate tax to the Trust. It only directed the Trust to reimburse the Estate as required by §2207A. Consequently, the Trust was not liable to the federal government for the estate tax in question, and thus cannot be allowed to deduct the amount on its fiduciary return.

No authority has been cited that the Trust was legally obligated to pay the estate tax to the IRS. The fact that the economic burden was passed to the Trust by both §2207A and the terms of the will of John T. Badham is not sufficient to allow the Trust to deduct the amount as taxes imposed on and paid by the Trust.

Cleveland v. Compass Bank, 1994 WL 503358 (Ala.), does not address the issue in dispute. Rather, the central issue in Cleveland was whether a Q-TIP trust should, in addition to being liable under §2207A for reimbursing the estate for federal estate tax, also be required to reimburse the estate for State estate tax resulting from the inclusion of the Q-TIP property in the estate. The Alabama Supreme Court held that §2207A obligated a Q-TIP trust to reimburse the estate for federal estate taxes, but not State estate taxes.

The language in Cleveland specifically relied on by the Taxpayer is "the circuit

court correctly held the (Q-TIP trust) was liable under section 2207A for that portion of the federal estate taxes attributable to the inclusion of the Q-TIP property in the estate (of decedent) . . .". Read in context, the Supreme Court held that the trust was liable to reimburse the estate for the taxes. The Court did not hold that §2207A made the trust liable to the federal government so as to allow the trust to deduct the amount on its fiduciary return.

The Trust also argues that the payment can be deducted pursuant to the Department's own Reg. 810-3-25-.01(2)(a)2.(i). That regulation provides that "[F]ederal estate taxes are an allowable deduction on the fiduciary return". However, when read in context, the above provision must be construed to mean that federal estate taxes can be deducted on the fiduciary return of the estate on which the taxes are imposed.

In summary, the estate tax in question was legally owed and actually paid by the Estate of Margaret O. Badham, not the Trust. The fact that the economic burden of the tax was passed to the Trust by §2207A and the will of John T. Badham does not alter the legal incidence of the tax on the Estate. Alabama law is clear that a taxpayer cannot deduct taxes paid if the taxes were levied on another taxpayer. Consequently, the Trust cannot be allowed to deduct the estate taxes paid by the Estate.

In the alternative, the Trust claims that it had sufficient distributions of property during 1991 that would have eliminated any tax liability in that year. The distributions were not included on the original return because the claimed estate tax deduction already reduced the Trust's liability to zero. As a precaution, the Trust filed an amended 1991 return with the Administrative Law Division on April 17, 1995 in the event that the estate

tax deduction in issue was denied. The amended return included information relating to the Trust distributions, but did not give exact figures pending a decision on the estate tax deduction issue. Based on the above holding that the estate tax deduction must be disallowed, the Trust is directed to complete the amended return and submit it to the Administrative Law Division. The return will be submitted to the Department for review and response. A Final Order will then be entered setting out the Trust's 1991 liability.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered August 2, 1995.

BILL THOMPSON
Chief Administrative Law Judge